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SUBJECT: INVESTMENT CLIMATE STATEMENT 2003 FOR SRI LANKA

REF: (A) STATE 128494

¶1. The following is the 2003 Investment Climate Statement for Sri Lanka. This report will be included in post's FY 2004 Country Commercial Guide to be sent separately.

Begin text.

INVESTMENT CLIMATE STATEMENT
SRI LANKA, JULY 2003

Openness to Foreign Investment

¶2. Sri Lanka actively welcomes foreign investment, which has become an important element of the country's economic growth. Sri Lanka opened its economy to foreign investment in 1978, long before its South Asian neighbors, but results have been mixed. Over the past twenty-five years, several hundred foreign investors have invested in the country but foreign investment flows have been weak in the last decade due to an ethnic conflict, and economic and political problems. This situation is improving due to current peaceful conditions in the country, economic reforms and an infrastructure development plan backed by increased foreign aid. Although many investors have done well, some have had problems with government practices and regulations.

¶3. Sri Lanka's economic growth has been reasonable, averaging 4.6 percent during the past decade. The country boasts unique human development achievements for a developing country. Sri Lanka's per capita income of $872, a literacy rate of over 90 percent and life expectancy of 72 years rank well above those of India, Bangladesh and Pakistan.

¶4. The current United National Front (UNF) Government, led by Prime Minister Ranil Wickremasinghe of the United National Party (UNP), came into office in December 2001 on a platform of peace and economic revival. It is strongly pro-business and investor friendly. The UNF government has moved to increase foreign investment and private sector activity in key sectors of the economy, initially concentrating on infrastructure development. The government has launched an extensive deregulation and economic reform program to facilitate private sector activity and improve economic growth. These programs are outlined in "Regaining Sri Lanka" (www.regainingsrilanka.org), a policy document of the Government of Sri Lanka. In support of these programs, the International Monetary Fund (IMF) approved a Poverty Reduction and Growth Facility (PRGF) (www.imf.org/external/country/LKA) for Sri Lanka in April 2003. International donors, including the IMF, have pledged a total of $4.7 billion in grants and concessional loans for Sri Lanka for a four-year period from 2003. These funds will be used to facilitate development in the south, and reconstruction in the north and east heavily damaged by the ethnic conflict.

¶5. The most notable achievement of the UNF government has been the ceasefire agreement signed on February 21, 2002, between the Government and the Liberation Tigers of Tamil Ealam (LTTE). Although ceasefire violations continue, the agreement has led to Sri Lanka's most stable and peaceful period of the last 20 years. Both parties have expressed their commitment to a negotiated settlement, and have held six rounds of talks with the Government of Norway acting as facilitator. As of August 2003, the LTTE, which pulled out of the peace talks in April 2003, is reviewing a government paper on an interim administration in the North and East. There is hope that the next round of peace talks may be held in the near future. The peace process has substantially improved the political, economic and investment

climate and has resulted in attracting substantial funding from multilateral and bilateral donors to rebuild the country. This has boosted foreign investor interest.

¶6. Numerous risks and challenges remain, however. The peace process could falter. Domestic political frictions could disrupt the peace process or hamper economic reform. Cohabitation tensions exist between the President and Prime Minister, representing opposing political parties. The President has delegated most of her executive powers to the Prime Minister and his cabinet of ministers, but retains constitutional power to dismiss the parliament and call for elections. Such an action could disrupt progress on peace and economic reforms. One major business concern in the medium term is the cost and supply of power. Sri Lanka has faced periodic power shortages since 1994, with the most recent period extending from mid 2001 to early 2002. Although new power plants are being added, the Government is yet to procure base load power needed to avert a power crisis in the medium term. Most businesses have installed on site generating capacity.

Board of Investment

¶7. The Board of Investment (BOI) (www.boi.lk), an autonomous statutory agency, is the primary government authority responsible for foreign investment. The BOI acts as a facilitator for investment. It is intended to provide "one-stop" service for foreign investors, including approval of projects, granting incentives and arranging services such as water, power, waste treatment and telecommunications. The BOI also assists in obtaining resident visas for expatriate personnel and facilitates import and export clearance.

¶8. The Bureau for Infrastructure Investment (BII) (www.boi.lk), a division of BOI, coordinates all private infrastructure projects. Projects are usually structured on the basis of build, own, operate (BOO), build, operate, and transfer (BOT) or build, own, operate and transfer (BOOT).

Laws Affecting Investment

¶9. The principal law governing foreign investment is Law No. 4 of 1978 (known as the BOI Act), including amendments made in 1980, 1983 and 1992, and implementing regulations established under the Act. The BOI Act provides for two types of investment approvals. Under section 17 of the Act, the BOI is empowered to grant concessions (see details below) to companies satisfying certain eligibility criteria. Investment approval under section 16 of the act permits entry for foreign investment to operate under the "normal" laws of the country and is applicable to investments that do not satisfy eligibility criteria for BOI incentives. Other laws affecting foreign investment are the Securities and Exchange Commission Act of 1987, amendments made in 1991 and 2003 and the Takeovers and Mergers Code of 1995. In addition, various labor laws and regulations affect investors. See sections below.

¶10. In early 2003, the Parliament passed a new BOI law to bring BOI's power to grant tax holidays and incentives with in the regular income tax law. BOI will retain most of the other powers granted under earlier laws; it will be responsible for investment approvals and granting of other incentives. The new law also provides for decentralization of some BOI activities to five regional economic development commissions formed under the BOI. These commissions are to promote development in the regions, provide facilities for investments, and develop and manage export processing zones. As of July 2003, although the new law had not come into force, some of the commissions had been established. When the new law comes into effect, the previous BOI Act of 1978 will be automatically repealed.

Foreign Equity and Sectors

¶11. Foreign equity participation of up to 100 percent is allowed in many sectors of the economy and the BOI gives automatic approval for most foreign investments.

¶12. The Government relaxed investment rules in early 2002, allowing 100 percent foreign investment in the following services: banking, finance, insurance,

stockbroking, construction of residential buildings and roads, supply of water, mass transportation, telecommunications, production and distribution of energy, professional services and the establishment of liaison offices or local branches of foreign companies. These services are regulated and subject to approval by various government agencies. The screening mechanism is non-discriminatory and, for the most part, routine.

¶13. Investment in some other sectors is restricted and subject to screening and approval on a case-by-case basis, where foreign equity exceeds 49 percent: shipping and travel agencies; freight forwarding; fishing; timber-based industries; growing and primary processing of tea, rubber, coconut, rice, cocoa, sugar and spices; and, finally, the production for export of goods subject to international quota. Foreign investment restrictions and government regulations also apply to international air transportation; coastal shipping; lotteries; large-scale mechanized gem mining; and "sensitive" industries such as military hardware, dangerous drugs and currency.

¶14. Foreign investment is not permitted in the following businesses: non-bank money lending; pawn-broking; retail trade with a capital investment of less than $1 million (with one notable exception: the BOI permits retail and wholesale trading by reputed international brand names and franchises with an initial investment of not less than US$ 150,000); personal services other than for the export or tourism sectors; coastal fishing; education of Sri Lankan citizens under 14 years; and award of local university degrees.

¶15. In general, the treatment given to foreign investors is non-discriminatory. In fact, some local companies have complained that they are discriminated against, while qualifying foreign investors can benefit from a wide range of advantages. Even with incentives and BOI facilitation, foreign investors can face difficulties operating here. Problems range from the mundane, but critical, matter of clearing equipment and supplies through customs speedily, to getting land for factories. The BOI encourages investors to locate their factories in industrial processing zones managed by the BOI to overcome land allocation problems. Investors locating in industrial zones also get access to relatively better infrastructure facilities such as reliable power, telecommunication and water supplies.

¶16. Government treatment of foreign investors in the privatization process has been largely non-discriminatory. Recently, however, the government sold part of retail operations of state-owned Ceylon Petroleum Corporation (CPC) to Indian Oil Corporation (IOC) without a formal tender process. Caltex, which had earlier acquired a government owned lubricant plant and obtained exclusivity in the sale of lubricants in CPC outlets till mid-2004, has also complained that the Government had reneged on the terms of the exclusivity agreement. Labor unions in the state-owned enterprises are often opposed to privatization and seem particularly averse to foreign owners, which has made the purchase of certain strategic entities problematic for new foreign owners. In addition, some privatization sales, particularly to foreign investors, have been controversial. Sometimes liberal and unwieldy concessions, not announced during the bidding process were granted to investors, and other times substantive changes were introduced once the process had begun.

Investment Trends

¶17. Foreign direct investment flows to Sri Lanka have averaged only about $140 million per year (excluding privatization receipts) in the past decade. Since the commencement of the peace process and improved investor confidence, foreign investment flows rose to over $245 million in 2002. FDI has funded mainly infrastructure projects (power, telecom, ports) and manufacturing industries. Investment approvals by BOI also rose sharply in
¶2002. FDI is expected to rise further this year to over $350 million. The stock market also recovered markedly in 2002 to become the second best performing market in Asia. The upward trend is continuing, with the market recording an all time high in June 2003. Both foreign direct investment and portfolio investment are expected to rise further due to increased investor confidence, private sector

participation in infrastructure and utilities, increased donor funding and incentives provided by the BOI. The UNF government's privatization and economic reform programs offer new investment opportunities for foreign investors. In addition, the Indo-Lanka Free Trade Agreement, which offers duty free entry into India for most products with 35 percent Sri Lankan value addition, offers a gateway for foreign investors in Sri Lanka to access markets in India. Currently, US companies avail themselves of this agreement adding 35% value in Sri Lanka and getting import duties into India reduced from as much as 40 percent to as little as zero.

Conversion and Transfer Policies

¶18. Sri Lanka has accepted Article VIII status of the IMF and has liberalized exchange controls on current account transactions. In early 2001, in response to a fall in Sri Lanka's foreign exchange reserves, the Central Bank brought in temporary controls on foreign exchange transactions, which have since been removed. There are no surrender requirements on export receipts, but exporters need to repatriate export proceeds within 120 days to settle export credit facilities. Other export proceeds can be retained abroad. Currently, contracts for forward bookings of foreign exchange are permitted for a maximum period of 360 days for the purposes of payments in trade and 720 days for the repayment of loans.

¶19. There are also no barriers, legal or otherwise, to the expeditious remitting of corporate profits and dividends for foreign enterprises doing business in Sri Lanka. Remittance of business fees (management fees, royalties and licensing fees) is also freely permitted. Funds for debt service and capital gains of BOI-approved companies exempted from exchange control regulations are freely permitted. Other foreign companies remitting funds for debt service and capital gains require Central Bank approval. All stock market investments can be remitted without prior approval of the Central Bank. Investment returns can be remitted in any convertible currency at the legal market rate. Controls on capital account (investment) transactions usually prohibit foreigners from investing in debt and fixed income securities. One exception has been the Central Bank's dollar denominated bond issues in the local market in 2001-2002, which were opened to foreign investors. It has been proposed to allow foreigners to invest in corporate debentures and government bonds.

¶20. Local companies require Central Bank approval to invest abroad. The process of granting approval for such investments was streamlined in 2002, resulting in a substantial increase in approvals.

Expropriation and Compensation

¶21. Since economic liberalization policies began in 1978, the Sri Lankan Government has never been legally found to have expropriated a foreign investment. Under the terms of the US/Sri Lanka Bilateral Investment Treaty (BIT), investors have the right to arbitration under the International Center for the Settlement of Investment Disputes (ICSID). A longstanding dispute involving an alleged expropriation of a US company's investment was satisfactorily resolved during 1998 after lengthy negotiations involving the company, the Sri Lankan Foreign Ministry, the Sri Lankan Attorney General and the US Embassy.

Dispute Settlement

Legal System

¶22. Sri Lankan commercial law is almost entirely statutory. The law was codified before independence in 1948 and reflects the letter and spirit of British law of that era. It has, by and large, been amended to keep pace with subsequent legal changes in the U.K. The court system is largely free from government interference. Procedures exist for enforcing foreign judgments. Litigation can be very time consuming. Several important legislative enactments regulate commercial matters: the Board of Investment Law, the Code of Intellectual Property, the Companies Act, the Securities and Exchange Commission Act, the Banking Act, and the Industrial Promotion Act. Most of these laws are being revised

to meet current business practices. In addition, a new Consumer Affairs Authority Act, with wide ranging provisions for consumer protection was enacted in ¶2003.

Bankruptcy Laws

¶23. The Companies Act and the Insolvency Ordinance e
provide for winding up insolvent companies, but existing legislation hinders smooth re-organization. Currently, there is no mechanism to facilitate the re-organization of financially troubled companies. The Termination Act, for example, prohibits employers from laying off workers even on the grounds of inefficiency. At the urging of the business community and the donor agencies, the Government took steps to reform labor laws in 2003. The Parliament has passed an amendment to the Termination Act to facilitate easier retrenchment, but its implementation has been delayed until the development of a compensation formula and an unemployment insurance scheme for displaced workers. The new termination law is expected to come into force in December 2003, but could be delayed.

¶24. In the absence of proper Bankruptcy Laws, extra judicial powers granted to financial institutions by law protect rights of the creditors and have helped to strengthen credit discipline. Lenders are able to enforce financial contracts through powers that allow them to foreclose on loan collateral without the intervention of courts. Recently, though, financial institutions have faced legal challenges, as defaulters obtain restraining orders on frivolous grounds due to technical defects in the recovery laws. Also, for default cases that are filed in courts, the judicial process is time consuming. The private sector has urged the Government to introduce US Chapter 11-style Bankruptcy laws. The financial community has requested strengthening of debt recovery laws.

Investment Protection

¶25. Foreign investments are, in principle, guaranteed protection by the constitution of Sri Lanka. The Government has entered into 24 investment protection agreements with foreign governments (including the United States) and is a founding member of the Multilateral Investment Guarantee Agency (MIGA) of the World Bank. Sri Lanka is also a founding member of the World Trade Organization. The Government has ratified the provisions of the convention on Settlement of Investment Disputes, which provides the mechanism and facilities for international arbitration through the ICSID of the World Bank.

¶26. The US-Sri Lanka BIT was ratified by both governments in early 1993. A bilateral treaty on avoidance of double taxation was signed in September ¶2002. The treaty shall enter into force upon ratification by the respective governments and the exchange of instruments of ratification.

¶27. Settlement of disputes through the Sri Lankan court system is subject to protracted and inexplicable delay. Aggrieved investors (especially those dealing with the Government of Sri Lanka on projects) have frequently pursued out-of-court settlements, which offer the possibility -- not frequently realized -- of speedier resolution of disputes.

Arbitration

¶28. The Arbitration Act of 1995 gives recognition to the New York Convention on recognition and enforcement of foreign arbitral awards. Arbitral awards made abroad are now enforceable in Sri Lanka. Similarly, awards made in Sri Lanka are enforceable abroad. A center for arbitration known as the Institute for the Development of Commercial Law and Practice (ICLP) has been established in Colombo, for the expeditious, economical and private settlement of commercial disputes. The ICLP appears unlikely to become involved in disputes involving the Sri Lankan Government, the source of most disputes involving US companies in recent years. Sri Lanka's first commercial mediation center was established in 2000, and became operational in mid 2001. Commercial mediation is conducted under the Commercial Mediation Act. Interest in mediation is still low.

¶29. The Labor Department has a process involving labor tribunals for settling industrial disputes with

labor, and compulsory arbitration is available when attempts to reconcile industrial disputes fail. The Parliament has passed an amendment to the Industrial Disputes Act to expedite labor dispute resolution through the Labor Tribunals of the Department of Labor. The Labor Commissioner typically becomes involved in labor-management mediation. The Labor Minister, and even the President, has intervened in particularly difficult cases.

Investment Disputes Involving U.S. Companies

¶30. There have been some troublesome investment and investment-related commercial disputes involving US companies in recent years. One such dispute, involving an alleged expropriation, was resolved in 1998 after 17 years of on-and-off negotiations between the company, the Government of Sri Lanka and the US Embassy.
¶31. A partially US-owned Internet service provider became involved in a major dispute in 1999 when its new "enhanced voice" service competed successfully with the national telecom service provider, Sri Lanka Telecom (SLT). Though the company had a valid license to provide enhanced voice service, SLT and the Government of Sri Lanka effectively blocked its implementation. Additional harassment and baseless charges were brought against one company employee, though intervention by the U.S. Embassy led to some respite. Changes in the Telecommunications Regulatory Commission under the new government have resulted in the resolution of many, though not all, of this company's difficulties. SLT still retains much control over telecom operations. The Sri Lankan government subsequently opened international telephony in early 2003 to all telecom technologies, though interconnection problems plague operators.

¶32. In another case, the Sri Lankan Supreme Court in May 2000 effectively blocked an existing investment agreement between the Government of Sri Lanka and a US mining company. Although the investment agreement was already signed and approved by the Sri Lankan cabinet, work on the project had not yet begun. A group of citizens filed a fundamental rights case, which under Sri Lankan law goes directly to the Supreme Court. The plaintiffs alleged in this case that their rights would be violated by implementation of the mining project, and the court upheld their complaint. Without any technical argument, the Court ruled that the project could not proceed before completion of a new series of detailed and highly comprehensive and expensive studies, some of which appear to be technically impractical. Because this is a Supreme Court decision, options for reversing the decision appear limited.

¶33. Another US investor with a substantial investment in an export manufacturing company has faced lengthy delays in a court case over a large insurance claim. The company instituted legal action in June 1999 and court proceedings are still ongoing with the company suffering financial losses as a result. In many disputes, defendants resort to obtaining injunctions, stay orders or postponements to drag cases on for years.

Performance Requirements/Incentives

Performance Requirements

¶34. The Board of Investment specifies certain minimum investment amounts for both local and foreign investors to qualify for incentives. Firms enjoying preferential incentives in the manufacturing sector in most cases are required to export 80 percent of production, while those in the service sector must export at least 70 percent of production. Sri Lanka complies with WTO Trade Related Investment Measures (TRIMS) Obligations.

¶35. Foreign investment is encouraged in information technology, electronic assembly, light engineering, automobile parts and accessories manufacture, industrial and IT parks, rubber based industries, information and communication services, tourism and leisure related activities, agriculture and agro processing, port related services, regional operating headquarters and infrastructure projects. Foreign investors are generally not expected to reduce their equity over time or to transfer technology within a specified period of time, except for build-own-transfer or other projects in which such terms are clearly specified.

¶36. Maintaining a certain level of employment is a condition in some BOI-approved enterprises. In addition, privatization agreements as a rule prohibit new owners from laying off workers, although the owners are free to offer voluntary retirement packages to reduce their workforce. Some foreign investors have received political pressure to hire workers from a particular constituency or a given list, but have successfully resisted such pressure with no apparent adverse effects.
¶37. Foreign investors who make an equity investment of $50,000 can qualify for a resident visa. Employment of foreign personnel is permitted when there is a demonstrated shortage of qualified local labor. Technical and managerial personnel are in short supply, and this shortage is likely to continue in the near future. Foreign employees attached to BOI-approved companies usually receive preferential tax treatment and do not experience significant problems in obtaining work or residence permits.

Investment Incentives

¶38. The Board of Investment has announced the following investment incentives:

¶39. Incentive Program I

Qualifying industries:
-- Non traditional manufacturing exports (excluding tea, rubber and coconut), and companies supplying to exporting companies. Minimum investment of $150,000;
-- Export oriented services. Minimum investment of $150,000;
-- Manufacture of industrial tools and/or machinery. Minimum investment of $150,000;
-- Small scale infrastructure. Minimum investment of $500,000;
-- Research and development. Minimum investment of $50,000;
-- Agriculture and agro processing industries. Minimum investment of $10,000;

Incentives: Above industries will qualify for a five-year tax holiday initially. A preferential tax of 10 percent in the 6th and 7th years follows the tax holiday. After the 7th year, a preferential tax of 15-20 percent will apply. In addition, these industries qualify for duty-free imports (generally, during the life of the project for export-oriented projects, and during the project implementation period for others). Exporting companies and export-oriented services will be exempted from exchange control regulations. They will also qualify for free repatriation of profits and dividends and free transferability of shares.

¶40. Incentive Program II

Qualifying Industries:
-- Information technology services such as call centers, data entry services, data centers, software development, hosting centers of e-governance related projects (a);
-- IT training institutes (b);
-- Regional operating headquarters providing following services to related businesses outside Sri Lanka: sourcing raw materials, R&D, technical support, financial and treasury management, marketing and sales promotion;
-- Any industrial, agriculture, service, or construction activity approved by the BOI. Minimum investment of $5 million.

(a)Minimum employment of 15 IT professionals is required in IT companies
(b) Minimum 300 students required for IT training institutes.

Incentives: Above industries will qualify for a 3-year tax holiday period initially. A preferential tax of 10 percent will apply in the 4th and 5th years. From 6th year onwards a preferential tax of 15-20 percent will apply. In addition, capital goods will be exempted from import duty.

Infrastructure development:

¶41. Companies acquiring existing companies in petroleum, power generation, transmission, development of highways, sea ports, airports, railway, water services, public transport, agriculture and agro processing and other infrastructure projects approved by the Finance Minister. Minimum investment of $12.5 million.

¶42. The above projects will qualify for tax holidays ranging from 5 to 10 years depending on the magnitude of investment. A preferential tax of 15 percent will follow the tax holiday. They will also qualify for duty free imports of capital goods.

¶43. Large-scale infrastructure projects in power generation, transmission and distribution; development of highways, seaports, airports, public transport and water services; establishment of industrial parks, and other infrastructure projects approved by the BOI. Minimum investment of $10 million.

¶44. The above investments will qualify for tax holidays ranging from 6 to 12 years depending on the size of the investment. A preferential tax of 15 percent will follow the tax holiday. They will also qualify for duty free imports of capital goods.

Indo-Lanka Free Trade Agreement

¶45. A preferential trade agreement, Indo Lanka Free Trade Agreement (ILFTA) (www.indolankafta.org), between Sri Lanka and India is in operation. Under this agreement, most products manufactured in Sri Lanka, with at least 35 percent domestic value addition (if raw materials are imported from India, domestic value addition required is only 25 percent), qualify for duty free entry to the Indian market. Tariff concessions for Sri Lankan products include zero tariffs on 4,150 items; 50 to 75 percent reduction for tea and garments under quota; 25 percent reduction for 528 items, and no reduction for 429 items (negative list). The two countries have begun discussions on services sector liberalization, although no specific goals have been set yet.

¶46. Sri Lanka also hopes to sign free trade agreements with Pakistan soon. These are seen as steps towards making Sri Lanka a regional hub and the gateway to South Asia and Middle East for foreign investors.

Prospects for U.S. Investment Under Indo Lanka Free Trade Agreement (ILFTA)

¶47. Foreign investors in Sri Lanka can enjoy preferential access to the Indian market, under the ILFTA. Domestic value addition of 35 percent is required to qualify for concessions granted under the agreement. The BOI hopes to attract foreign joint ventures to Sri Lanka under the ILFTA. Indian imports amounted to over $49 billion in 2002. The BOI's strategy is to identify products imported into India and to target its investment promotion efforts to countries and companies manufacturing them. The US is one such country; the US accounts for about 7.5 percent of Indian imports valued at $3.7 billion in ¶2002. A majority of these products would qualify for substantial duty concessions if exported from Sri Lanka under the ILFTA. The BOI encourages US manufacturing companies and regional operating headquarters to relocate in Sri Lanka to benefit from ILFTA. The BOI has identified the following sectors for investment promotion in the US: electronics, light engineering, pharmaceuticals/cosmetics, information technology and financial services.

¶48. For further information on investment incentives and other investment-related issues, potential investors are encouraged to contact the Board of Investment directly. The BOI can be found at www.boi.lk, or reached via e-mail at info@boi.lk

Right to Private Ownership and Establishment

¶49. Private entities are free to establish, acquire and dispose of interests in business enterprises. Private enterprises enjoy benefits similar to those granted to public enterprises, and there are no known limitations on access to markets, credit or licenses. Foreign ownership is allowed in most sectors. Private land ownership is limited to fifty acres per person. About 80 percent of the land in Sri Lanka is owned by the Government, including most tea, rubber and coconut plantations. In the past three and a half years, the Government divested most of these plantations to the private sector on 50-year lease terms as part of ongoing privatization efforts. Although state land for industrial use is usually allotted on a 50-year lease, 99-year leases may also be approved on a case-by-case basis, depending on the nature of the project.

¶50. Foreign investors can purchase land from private sellers. The Government removed a 100 percent tax on land transfers to foreigners in March 2002.

Protection of Property Rights

Property rights

¶51. Secured interests in property are recognized and enforced. A fairly reliable registration system exists for recording private property such as land, buildings and mortgages. The legal system is nondiscriminatory and protects and facilitates acquisition and disposition of property rights by foreigners.

¶52. Private farmers are working state-owned lands under varying tenure agreements, ranging from restrictive tenures to land grants. These lands have ill-defined property rights. A World Bank-funded project is underway to develop a legal framework for implementing a titling system for land. This will also remove restrictions related to the sale, leasing and transfer and mortgaging of rural lands previously distributed to farmers.

Intellectual Property Rights Protection

¶53. Sri Lanka is a party to major Intellectual Property Agreements including the Berne Convention for the protection of literary and artistic works, the Paris Convention for the protection of industrial property, the Madrid Agreement for the repression of false or deceptive indication of source on goods, the Nairobi Treaty, the Patent Co-operation Treaty, the Universal Copyright Convention and the Convention establishing the World Intellectual Property Organization (WIPO). Sri Lanka's intellectual property law is based on the WIPO model law for developing countries. Sri Lanka and the US signed a Bilateral Agreement for the Protection of Intellectual Property Rights in 1991, and Sri Lanka is also a party to the Trade Related Intellectual Property Rights (TRIPS) Agreement in the World Trade Organization.

¶54. In July 2003, the Sri Lankan Parliament passed a new intellectual property law to replace the Intellectual Property Act of 1979. The new law is expected to come into force in August 2003 and will meet both US-Sri Lanka bilateral IPR agreement and TRIPS obligations (due on January 1, 2000), to a great extent. The law will govern copyrights and related rights, industrial designs, patents for inventions, trademarks and service marks, trade names, layout designs of integrated circuits, geographical indications, unfair competition and undisclosed information. All trademarks, designs, industrial designs and patents must be registered with the Director General of Intellectual Property.

¶55. Infringement of Intellectual Property Rights (IPR) is a punishable offense under the new law. Intellectual Property Rights come under both criminal and civil jurisdiction. Relief available to owners under the new law includes injunctive relief, seizure and destruction of infringing goods and plates or implements used for the making of infringing copies, and prohibition of importation and exports. Enforcement, however, is a serious problem, as is public awareness of IPR. Domestic implementing legislation, under the old law, has been very weak and the Government does not act as an enforcer of IPR laws. At present, aggrieved parties must, on their own, seek redress of any IPR violation through the courts, which can be a frustrating and time-consuming process. Although the legal system is well-established and non-discriminatory, it is fraught with long delays.

¶56. It will take time before new procedures and court precedents are established. In addition, Sri Lanka needs to ratify and conform to the WIPO Performances and Phonograms Treaty (WPPT) and the WIPO Copyright Treaty (WCT). Ratification of these two treaties will support electronic commerce, protect the rights of performers and producers of phonograms and the rights of authors in their literary and artistic works, and offer an adequate basis to fight international piracy in view of the new technological developments. Meanwhile, local agents of reputed US and other international recording companies, software development companies and motion picture companies continue to complain

that lack of IPR protection is damaging their businesses. The Embassy, along with key industry players including the IFPI, continues to lobby the Government to improve Sri Lanka's IPR regime.

¶57. Patents are granted for inventions, with the following exceptions: discoveries, scientific theories and mathematical methods, plant or animal varieties (other than micro biological processes) and essentially biological processes for the production of plants and animals (other than non biological and microbiological processes), business rules and methods, methods of treatment by surgery or therapy, and diagnostic methods practiced on the human or animal body. The new law will also permit compulsory licensing and parallel imports of pharmaceutical products. The compulsory licensing will allow government to grant licenses to manufacture certain drugs, overruling patent licenses, in a national emergency. The parallel imports will allow the import of a branded drug from an alternative source. A patent is valid for 20 years from the date of grant, but must be renewed annually.

¶58. Copyrights are not registered. A work is protected automatically by operation of law. Original literary, artistic, and scientific works including computer programs and databases are protected under the new law. The enforcement limitations described above apply to copyrights, including software.

¶59. Sri Lanka recognizes both trademarks and service marks. The exclusive right to a mark is acquired by registration. A mark may consist of words, slogans, designs, etc. Protection also is available to well known marks not registered in Sri Lanka. Registered trademarks are valid for ten years.

Transparency of the Regulatory System

¶60. The BOI strives to inform potential investors about laws and regulations that may affect operations in Sri Lanka. Laws pertaining to tax, labor and labor standards, exchange controls, customs, environmental norms, building and construction standards are in place. Some of the laws and regulations are not freely available and are difficult to access. Foreign and domestic investors often complain that the regulatory system allows far too much leeway for bureaucratic discretion. Outdated regulations and rigid administrative procedures imposed by public sector institutions have been identified as impediments to private sector growth. Effective enforcement mechanisms are sometimes lacking and coordination problems between the BOI and relevant line agencies frequently emerge. Lethargy and indifference on the part of mid- and lower-level public servants compound transparency problems. Non-availability of technical capacity within the Government to review financial proposals for private infrastructure projects also creates problems during tendering. The Government has begun to carry out extensive deregulation to facilitate private sector activity.

¶61. Although many foreign investors, including US firms, have had positive experiences in Sri Lanka, some have encountered significant problems with government practices and regulations. For example, one foreign company that had obtained a waiver of a particular requirement in order to obtain a license was later told it must meet the requirement to continue to be qualified for the license, with no advance warning and little justification. Some multinational firms have experienced extensive unexplained delays in trying to reach agreement on investment projects. Others have had contracts inexplicably canceled without compensation, even after those contracts had been approved by the Sri Lankan Cabinet.

¶62. The partially US-owned Internet service provider mentioned above encountered further difficulties in 1999 when its "enhanced voice" service competed successfully with Sri Lanka Telecom (SLT) which is partly owned by the Government. The company had a valid license to offer enhanced voice service, but SLT claimed otherwise. Although technical questions regarding the interpretation of licenses should in theory be resolved by the industry regulatory authority, this option was less attractive to the company because the Director General of the Regulatory Authority at that time was in this case a former CEO of SLT with a bias towards SLT. This problem was partially resolved in 2002 with the appointment of a new Telecom Regulator and in 2003,

when the government fully liberalized the external gateway operations. Implementation and enforcement of the new regulations is inconsistent.

Efficient Capital Markets and Portfolio Investment

Availability of financial resources

¶63. Retained profits finance about 70 percent of private investment, with short term borrowing financing a further 20 percent of investment. The stock market and corporate securities market have not been significantly used to raise capital. FDI finances about 4 percent of investment.

¶64. The State consumes over 50 percent of the country's domestic financial resources, and has a virtual monopoly on the management and use of long term savings in the country. This inhibits the free flow of financial resources to product and factor markets. In the past, high interest rate volatility due to excessive use of short term borrowing by the state increased intermediation cost leading to higher costs to other borrowers. The current government has initiated a low interest rate regime and has begun to replace short-term government debt with long-term debt. Together with lower inflation and improved government fiscal discipline this contributed to lower interest rates during the past 18 months. The Central Bank has decreased its key monetary policy rates significantly during this period. The prime lending rate currently averages 10.36 percent compared with about 21.5 percent in December 2000. Foreign investors are allowed to access credit on the local market. They are also free to raise foreign currency loans.

¶65. In 2002, there was a revival in the Colombo stock market. A total of Rs 4.0 billion (approx. $42 million) was raised in the primary market by way of new equity and debt, reflecting the potential for companies to raise funds through the market. Due to economic and political problems and depressed stock market conditions, capital raised in the primary market was extremely low during 1999-2001.

¶66. The International Finance Corporation (IFC), the arm of the World Bank group which invests in the private sector, also provides equity and debt financing for private sector ventures in Sri Lanka such as infrastructure, financial markets, tourism, IT, healthcare and education as well as general manufacturing and services. The IFC's current portfolio in Sri Lanka is about $75 million.

Credit Instruments

¶67. Commercial banks and two development finance institutions, the National Development Bank (NDB) and the Development Finance Corporation of Ceylon Bank (DFCC), are the principal source of bank finance. Bank loans are the most widely used credit instrument for the private sector. Financial institutions such as the DFCC and some commercial banks also raise syndicated bank loans to fund large-scale investment projects undertaken by the private sector.

¶68. The domestic debt market in Sri Lanka is still at a very nascent stage. A few leading companies and financial institutions have raised capital through credit instruments such as debentures, corporate bonds and commercial paper. In the past, high interest rates on government bonds due to excessive government borrowing have made it unprofitable for private companies to raise capital through corporate bonds. This situation is set to change with the current relatively low interest rates on government bonds. In 2002, Rs 2.7 billion ($27.8 million) was raised through listed debentures. Corporate debt of both publicly listed companies and companies not listed on the stock exchange are traded through the stock exchange. Fitch IBRC (formerly Duff and Phelps Credit Rating Company) which opened an office in Colombo in 1999, is the only credit rating agency in Sri Lanka. The local branch company, Fitch Rating Lanka Ltd, is a joint venture between Fitch IBRC, IFC, the Central Bank of Sri Lanka and several local financial institutions. Fitch Lanka rates debt instruments of corporations, banks and other financial institutions in accordance with international rating standards. But a strong credit rating culture has not yet developed in Sri Lanka. This is set to change as the government has made credit ratings mandatory for all deposit taking institutions from January 2004. Credit ratings are also mandatory for all varieties of debt instruments.

Accounting Standards

¶69. There is an active and relatively competent accounting profession, based on the British model. The source of accounting standards is the Institute of Chartered Accountants of Sri Lanka (ICASL) and standards are constantly updated to reflect current international accounting and audit standards. Due to the lack of an adequate enforcement mechanism, however, problems with the quality and reliability of financial statements exist. Sri Lanka carried out a major revision of accounting and auditing standards in September 1997. Since then, the standards have been periodically updated to meet new international standards adopted by the International Accounting Standards Board (IASB). As of mid 2003, there were five new international standards awaiting adoption in Sri Lanka.

¶70. Sri Lanka accounting standards are applicable for all banks and companies listed on the stock exchange and all other large- and medium-sized companies in Sri Lanka. Accounts of such business enterprises are required to be audited by professionally qualified auditors holding ICASL membership. ICASL has recently published accounting standards for small companies as well. Companies in Sri Lanka now have the choice of adopting International Financial Reporting Standards (IFRS) of the IASB. An Accounting Standards and Monitoring Board (ASMB) which started operations in April 2000, is responsible for monitoring compliance with Sri Lanka accounting and auditing standards. In 2001, the ASMB has reviewed financial statements of 397 companies and found major deviations in 9 percent of the financial statements.

Securities Exchange Commission

¶71. The Securities and Exchange Commission (SEC) regulates the securities market in Sri Lanka. The SEC law was revised in 2003, enhancing its coverage and investigative powers. The SEC now covers stock exchanges, unit trusts, stock brokers, listed public companies, margin traders, underwriters, investment managers, credit rating agencies and securities depositories.

¶72. Foreign investors can freely purchase up to 100 percent of equity in Sri Lankan companies in numerous permitted sectors. In order to facilitate portfolio investments, country funds and regional funds are also allowed to invest in Sri Lanka's stock market; such funds must first receive Ministry of Finance approval to operate in Sri Lanka. These funds make transactions through share investment external rupee accounts maintained in commercial banks.

¶73. Sri Lanka's SEC was rocked by a scandal in early 2003, tarnishing the image of the market watchdog. The SEC Chairman and another leading businessman were implicated for insider dealing at a blue chip local conglomerate where they were both directors. Initial attempts by the SEC secretariat to institute legal actions against the two were blocked by the SEC Board of Directors. Later, the Attorney General ruled that the SEC Board had acted improperly, casting doubt on the board members' credibility. Since then, the SEC Chairman has resigned. He has pleaded innocent and has filed legal action, opposing SEC decision to prosecute. The SEC is awaiting a decision on this case to proceed with legal action. The SEC Director General, who was instrumental in pursuing the case, also resigned, citing unwarranted interference by the SEC board of directors to stop investigations.

¶74. The SEC scandal has caused many to call for increased corporate governance and accountability in the private sector. Some business consultants have asked for laws such as the recent US Sarbanes-Oxley Act to regulate financial services and professional services organizations.

Colombo Stock Exchange

¶75. The Colombo Stock Exchange (CSE), while small by "big emerging market" standards, is one of the most efficient in the region. The CSE is fully automated, with automated trading and clearing and settlement systems. The CSE has a rolling settlement period of five days for buyers and six days for sellers. Fifteen local and foreign joint venture brokers currently operate at the CSE. Foreign stock-brokers are permitted to hold up to 100 percent equity in stock broking firms operating at the CSE. SEC has a settlement guarantee fund with an initial capital of Rs 100 million ($1 million) which aims to guarantee

the settlement of trades between clearing members of the exchange. The Chartered Financial Analysts (CFA) program is conducted in Sri Lanka.

¶76. Acquisition of companies through mergers and takeovers is governed by the Takeovers and Mergers Code of 1995 made under the Securities and Exchange Commission of Sri Lanka Act. This law applies only to companies listed on the Colombo Stock Exchange. Acquisition of more than a 30 percent stake of a listed company requires the buyer to make an offer to all other shareholders. There are 240 companies listed on the stock exchange. The articles of association of a few listed companies restrict foreign equity to certain levels.

¶77. In mid-2003, CSE was one of the best performing markets in the world. In June 2003, the stock market hit an all time high. The cease-fire agreement between the Government of Sri Lanka and the LTTE and economic reforms has helped to boost investor confidence. During 1998-2001, the Colombo Stock Market experienced a sharp downturn due to a variety of local and international factors. The CSE was removed from the Morgan Stanley Capital International (MSCI) Index in 2001 due to a drop in market capitalization and liquidity. The CSE hopes to get reclassified in the MSCI soon. The single overriding factor inhibiting the sustainable development of the stock market has been the conflict in the North and East and its effect on investor confidence and the economy as a whole. Other broader issues include lack of liquidity and limited market size. Improvements are also needed in corporate governance, accountability and public disclosure in companies. The Accounting and Auditing Standards Monitoring Board, the Ceylon Chamber of Commerce, the Colombo Stock Exchange and professional accounting bodies are taking initiatives in these areas.

Banking System

¶78. Sri Lanka has a fairly well diversified banking system. There are 23 commercial banks, consisting of eleven local banks and twelve foreign banks. In addition, there are thirteen local specialized banks. The banking sector moved towards consolidation in 2001-2002 as four foreign commercial banks, ABN Amro, Nova Scotia, Habib Bank AG Zurich and American Express left Sri Lanka after selling their operations. Citibank NA is the only US bank operating in Sri Lanka and has expanded its operations recently. In 2002, the American Express Bank sold its banking operations in Colombo in keeping with its global strategy. Sri Lanka experienced its first bank failure in December 2002, when the Central Bank took action to revoke the license of a small licensed specialized bank as its financial condition deteriorated to insolvency. There has not been any fallout for other banks from this incident as of June 2003. At the request of the Central Bank, two other small troubled commercial banks are being taken over by larger banks. Sri Lanka's banking sector has various outdated regulations that restrict banking sector consolidation. The Government is proposing to amend the Banking Act to further facilitate mergers and acquisitions in the banking sector in a strategy to help consolidation. Further, the Government has launched an extensive financial sector reforms program, which is set to overhaul the financial sector to suit modern times.

¶79. The Central Bank is responsible for supervision of all banking institutions. Wide-ranging improvements have been made in banking regulation and in public disclosure of banking sector performance. In 1997, the Central Bank issued, for the first time, directives on loan classification, suspension of interest, provisioning, investments in equity, and the acquisition of immovable property, and it tightened its directives on capital adequacy and single borrowers. Subsequently, the Central Bank has expanded its reporting system to monitor compliance. Standards for the public disclosure of banking sector data were raised considerably in 1999. With the exception of classification and provisioning, all Central Bank requirements are up to international standards. In 2002, the Monetary Law Act (MLA) was amended to provide Central Bank broader supervisory powers and greater independence. It also contained improvements to the payment and settlement systems. The bank also commenced additional training programs for bank supervision staff and introduced more on-site and off-site surveillance during the year. The Central Bank also issued a code of corporate

governance for banks and financial institutions in ¶2002.

¶80. Despite recent progress, bank supervision remains weak. Central Bank supervision as well as auditing practices of private audit firms came under criticism after the recent specialized bank failure mentioned above. The Central Bank is planning to obtain the services of an international expert to strengthen bank supervision in 2003. In addition, the Government is proposing to introduce amendments to the Banking Act to enhance Central Bank's supervision capacity (including fit and proper tests of new entrants and penal violations for violation of prudential laws). Further amendments to the MLA are also expected in the next two years under ongoing financial and legal reforms programs.

State Owned Banks

¶81. Total assets of the commercial banks stood at Rs 788 billion ($8.1 billion) as of December 31, 2002. Despite a gradual loss in market share, the two state-owned commercial banks, Bank of Ceylon and People's Bank with assets of Rs 228 billion and Rs 180 billion, respectively, still dominate banking, making up a little over half of all assets and liabilities. The state banks are weak, with high NPLs, inadequate loan loss provisioning, low equity/assets ratio. Much of that is due to past government interference. Since most of the bad debt of the two banks is implicitly guaranteed by the state, these problems do not affect the credibility of the banking system in Sri Lanka.

¶82. The weaknesses in the state banks, however, make it possible for other inefficient banks to operate and for the more efficient banks to make higher profits than they would otherwise. The World Bank and IMF have identified the dominance of the inefficient state banks as a main constraint for development of the financial sector. In a bid to overcome the problems at the state-owned banks, the Government has been trying to reorganize the banks since mid 1998. Both banks have launched restructuring exercises to return to commercial viability in the medium term. Top management at both Bank of Ceylon and People's Bank now contains members from the business community and experienced bankers from the private sector. Corporate governance practices in the state banks, however, remain questionable.

¶83. Bank of Ceylon met most of the World Bank established restructuring targets by end 2002, including loan recovery and return on assets. The situation at People's Bank, however, remains grave. Although the People's Bank strengthened its financial position, reflecting increased recoveries and higher margins and posted a profit in 2002, the Bank is insolvent. The Government has agreed on the urgent need for the restructuring of the Peoples Bank under the PRGF with the IMF. As a first option, the Government has set a December 2003 target to sell the Bank as a single unit, after transferring problem loans to an asset management company. If this fails, it is proposed to separate the bank into a savings and commercial bank-the former remaining under the government and the latter divested. In either case, the Government aims to complete the restructuring by March 2004.

Private Commercial Banks and foreign banks

¶84. Private commercial banks and foreign banks operating in Sri Lanka generally follow more prudent credit policies and as a group are in better financial shape. Banking sector profits increased quite sharply in 2002 after suffering badly in 2001 due to the economic slowdown. Nonetheless, the private banking sector also remains trapped with a high level of non-performing loans, despite high margins. In 2002, the average rate of non-performing loans to total loans was 19 percent for the two state commercial banks, 15.3 percent for private domestic banks and 12.1 percent for foreign banks operating in Sri Lanka. There are concerns regarding inadequate loan loss provisioning and low operational efficiency in some local private banks. Foreign banks tend to make provisions in line with international best practices as most foreign bank branches are subject to home country supervision in addition to that of the Central Bank of Sri Lanka. To help improve bank performance, an Asset Management Company Law is being prepared with World Bank and IMF assistance. The law aims to provide troubled banks with a mechanism to effectively deal with their non-performing loans.

¶85. Credit ratings will become mandatory for all banks operating in Sri Lanka from January 2004. Currently, six banks have been assigned ratings by Fitch Ratings: State-owned National Savings Bank:SL AAA; Citibank NA, Colombo:SL AAA; Commercial Bank of Ceylon:SLAA+,.DFCC Bank:SL AA; Bank of Ceylon:SL AA- and Hatton National Bank: SL A.

Capital Adequacy

¶86. Sri Lanka adopted capital adequacy standards set by the Basel Committee on banking regulations and supervisory practices in 1993. The Central Bank has raised the minimum capital adequacy standards from 4.5 to 5 percent for core capital (Tier I) and from 9 to 10 percent for risk weighted assets (Tier I and Tier II) from January 2003. Further enhancing banking sector stability, Central Bank has also imposed capital adequacy standards on foreign currency banking units from June 30, 2003.

¶87. The two state owned banks' risk based capital asset ratio (CA) at 0.3 percent was well below the minimum in 2002. For private domestic banks, CA averaged 9.3. The foreign banks comfortably met the requirement at 36.6 percent.

Political Violence

¶88. Since early 2002, there has been a marked improvement in the business climate due to the peaceful atmosphere prevailing in the country. This is in contrast to the period between 1983-2001, when the country was plagued by ethnic conflict, a civil war and related urban terrorism. The fighting between the Liberation Tigers of Tamil Eelam (LTTE) and the Sri Lankan military was primarily in northern and eastern Sri Lanka, but other parts of the country suffered sporadic terrorist attacks. Since 1997, the LTTE has been on the State Department list of foreign terrorist organizations. Terrorist activities of the LTTE have declined significantly since late 2001 when the LTTE declared a unilateral cease-fire and signed a formal open-ended cease-fire agreement on February 22, 2002 with the hope of ending the war. The two parties have held six rounds of peace talks with the government of Norway acting as facilitator. The LTTE, which temporarily suspended its participation in the peace talks in April 2003 was giving signals of returning to the talks as of July 2003. Although several ceasefire violations have been recorded, the enduring ceasefire in Sri Lanka has increased investor confidence and has allowed the government and private sector to embark on new investment and business initiatives. There are no guarantees that the process will succeed in ending the years of conflict, but optimism is stronger than at any time in the past decade.

¶89. During the almost 19 years of war, tourists and foreign business representatives have not been terrorist targets but have suffered collateral injury during attacks on other targets. On July 24, 2001 the LTTE attacked the International Airport and destroyed both commercial and military aircraft. Several military personnel were killed in the attack, military and airport employees were injured, and civilians were caught in crossfire. Sri Lankan Airlines, jointly owned by the Government of Sri Lanka and Emirates Airlines of Dubai, lost several commercial aircraft in the attack. The LTTE has also attacked several commercial ships flying foreign flags in the waters off the north and east of the country. In response to these attacks, insurers imposed war risk insurance surcharges on aircraft and ships using Sri Lankan seaports and airports. These surcharges have since been lifted. During the conflict, the LTTE also detonated several large bombs in Colombo's financial and business districts causing extensive damage to life and property. Very few foreigners were injured in these terrorist incidents due to the LTTE's policy of targeting local interests. There have been no major attacks since the peace process began on December 24, 2001. In recent months (April-July 2003), however, the LTTE is implicated in the slayings of several anti-LTTE politicians of Tamil heritage. There have also been several violent incidents at sea.

¶90. In 1998, the US Peace Corps suspended operations in Sri Lanka after LTTE bombings occurred outside the Colombo area, including places such as Galle in the south and Kandy in the central highlands -- locations where volunteers had been posted, based on the low probability of terrorist attacks. There are efforts

by the current government to bring the Peace Corps back and a Peace Corps assessment team is expected in September.

Corruption

¶91. The country has fairly adequate laws and regulations to combat corruption, but they are unevenly enforced. US firms identify corruption as a constraint on foreign investment, but, by and large, it is not a major threat to operating in Sri Lanka. Corruption is a persistent problem in customs clearance and enables wide-scale smuggling of certain consumer items, to the detriment of legitimate manufacturers and importers. Corruption appears to have the greatest effect on investors in large projects as well as government procurement and tendering, especially in previous defense purchases. The law states that giving or accepting a bribe is a criminal offense and carries a maximum sentence of seven years imprisonment and a fine at the discretion of the courts. The Bribery Commission is the main body responsible for investigating allegations of bribery and corruption. The function of the Bribery Commission, under Act No 19 of 1994, is to investigate allegations brought to its attention and institute proceedings against responsible individuals in the appropriate court. The commission was appointed for a 5-year term in December 1999 but has not been effective in dealing with bribery or corruption. As of June 2003, this commission was not functioning, due to the failure of the Constitutional Council to fill a vacancy caused by the death of one of the three commissioners.

¶92. Few have been found guilty of corruption in recent years. Highly publicized efforts to investigate bribery and corruption have failed, damaging public confidence in such processes. During the latter part of previous Government's term, corruption charges were leveled against politicians and top officials in charge of key government corporations, but no politician has been prosecuted for bribery or corruption. In 2002, the Criminal Investigation Department raided bank vaults of a former senior cabinet minister and discovered a large cache of certificates of deposits for millions of rupees. The Bribery Commission is investigating this case. In April 2001, the Chairman of the Board of Investment was forced to resign on allegations of bribery and corruption. He is currently being prosecuted for bribery. A handful of other key government officials, including the former General Manager of Railways, are being prosecuted for corruption and bribery, but prosecutions are proceeding slowly.

¶93. The current UNF government came into power promising a corruption-free regime, but corruption allegations continue to surface regularly. In response to various reports of corruption and lack of an effective mechanism to handle corruption complaints, the ruling United National Party has recently appointed an internal party committee to investigate corruption allegations of its members. The Government is also taking other steps to combat corruption. All tenders presented for Cabinet approval now need to be routed through a cabinet subcommittee chaired by the Minister of Finance. Tender board decisions presented to the subcommittee are vetted thoroughly by Treasury officials. The Government has taken additional measures to regulate defense spending by appointing a Budget Monitoring Committee and a Procurement Monitoring Committee in the Defense Ministry.

¶94. Transparency International (TI), an international "watchdog" organization promoting anti-corruption strategies, opened a national chapter in Sri Lanka in September 1999. In TI's Corruption Perception Index for 2002, Sri Lanka was ranked 52 among 102 countries with a score of 3.7 out of a clean score of 10, reflecting a relatively high perceived level of corruption among politicians and public officials. TI has asked the international donor community to ensure transparency and clear lines of accountability in the disbursement of donor aid for post war reconstruction.

Bilateral Investment Agreements

¶95. The Government of Sri Lanka has signed Investment Protection Agreements with the United States (which came into force in May 1993) and the following countries:

¶1. Belgium
¶2. People's Republic of China
¶3. Denmark
¶4. Egypt
¶5. Finland
¶6. France
¶7. Germany
¶8. Indonesia
¶9. India
¶10. Iran
¶11. Italy
¶12. Japan
¶13. Korea
¶14. Luxembourg
¶15. Malaysia
¶16. Netherlands
¶17. Norway
¶18. Romania
¶19. Singapore
¶20. Sweden
¶21. Switzerland
¶22. Thailand
¶23. United Kingdom

¶96. A bilateral treaty on avoidance of double taxation between Sri Lanka and United States is currently awaiting ratification by both sides.

¶97. Foreign investors not qualifying for BOI incentives such as tax and exchange control exemptions or concessions will be liable to pay taxes on corporate profits, dividends, and remittance of profits. They will also be liable to pay a Value Added Tax on goods and services. The Government has also imposed a tax of 0.1 percent on debits to any current or savings account maintained at any bank in Sri Lanka. Debits made to accounts of Government and international organizations are excluded. Accounts maintained at Foreign Currency Banking Units, accounts maintained for stock exchange transactions (SIERA) and resident and non-resident foreign currency accounts are exempted from the tax. The Embassy encourages prospective US investors to contact an international auditing firm operating in Sri Lanka to assess their tax liability.

OPIC and Other Investment Insurance Programs

¶98. The US and Sri Lanka concluded in 1966 (and renewed in 1993) an agreement that allows the Overseas Private Investment Corporation (OPIC) to provide investment insurance guarantees for US investors. OPIC currently provides coverage to banking and power sector investments in Sri Lanka. Sri Lanka's membership in the Multilateral Investment Guarantee Agency (MIGA) offers the opportunity for insurance against non-commercial risks.

¶99. Over $12 million is spent annually by the US Embassy and other US Government institutions in Sri Lanka. This amount can potentially be utilized by OPIC to honor an inconvertibility claim; however, no such claims have been made to date in Sri Lanka. The Embassy purchases local currency at the financial rate. The Sri Lankan Rupee has been quite stable during past 12 months. The currency is not expected to fluctuate by more than 10 percent relative to the US dollar over the next year.

Labor

Labor Force

¶100. Sri Lanka's labor force is literate and trainable, although weak in certain technical skills. More computer skills training programs are becoming available, but the demand still outpaces supply and many qualified workers seek employment overseas. The average worker has eight years of schooling. Two-thirds of the labor force is male. The unemployment rate (employment is defined as one who worked for pay, profit or unpaid family gain for one or more hours during the survey week) in the third quarter of 2002 was 9.1 percent, with an estimated 641,000 of a total labor force of 7.1 million out of work. (Labor force data excludes the North and East; armed forces personnel deployed away from home and Sri Lankan migrant workers abroad.) Including unpaid family workers, the unemployment rate is 10.0 percent. Youth unemployment remains a critical problem. Nearly 80 percent of unemployed persons are in the 15-29 year age range. Over 50 percent of unemployed youth are educated at the O-Level (10th grade) or higher.

¶101. A significant proportion of unemployed seek "white collar" jobs, and most sectors facing labor shortages offer manual or semi-skilled jobs or require technical or professional skills such as management, marketing, information technology, accountancy and finance, and English language. The Government has recognized the challenge of reformulating the educational system to meet the needs of the private sector better, but it will take time before the mismatch of skills to requirements is addressed. Asian Development Bank and the World Bank have recently approved projects to improve distance learning and tertiary education. The Government has also embarked on a "Youth Corps" program to provide job related training to the unemployed.

Migrant Workers Abroad

¶102. There are an estimated 970,000 Sri Lankan workers abroad. The majority of Sri Lankan workers abroad is unskilled (housemaids and laborers) and is located primarily in the Middle East. Sri Lanka is also losing many of its technically and professionally qualified workers to more lucrative jobs abroad.

Labor Regulations, Cost of Labor

¶103. Labor is available at a relatively low cost, though it is priced higher than in other South Asian countries. Child labor is prohibited and is virtually nonexistent in the organized sector though child labor occurs in informal sectors. The minimum legal age for employment is set at 14. Most permanent full-time workers are covered by laws pertaining to maximum hours of work, minimum wage, leave, the right of association, and safety and health standards. The Termination of Employment Act (TEA) makes it difficult to fire or lay off workers who have been employed more than six months for any reason other than serious, well-documented disciplinary problems. Disputes over dismissals can be brought to a labor tribunal administered by the Ministry of Justice. The labor tribunals have large backlogs of unresolved cases. Certain labor disputes founded upon fundamental rights (allegations of termination/transfers based upon discrimination, etc.) can be brought directly to the Supreme Court. TEA prevented many companies from laying off permanent staff in 2001 despite economic contraction and export slowdown. Consequently, affected companies had to bear the cost of maintaining excess labor.

¶104. There is widespread belief that the labor laws and a plethora of holidays are dampening productivity. The full moon day of each month, if it falls on a weekday, is a paid holiday. There are also eight other public holidays. The public sector and banks enjoy additional holidays. The statutory holidays are in addition to 21 days annual/casual leave and approximately 21 days sick leave (number of days for sick leave is at the discretion of the management). In addition, female employees are entitled to 84 days fully paid maternity leave for the first two confinements.

Labor reforms

¶105. The current Government has embarked on a program to carry out needed labor reforms covering legal reforms, training and employment and increasing productivity of the labor force. In January 2003, the Parliament passed amendments to the TEA and the Industrial Disputes Act (IDA) to improve labor mobility. The amendments to TEA seek to facilitate easier termination, and provided for a standard compensation formula and an unemployment benefit scheme. Amendments to the IDA included time-bound labor dispute resolution rules to expedite labor dispute resolution. These laws will come into effect only after a new compensation formula and a new unemployment insurance scheme are established. The current social safety net for the unemployed is inadequate and compensation is subject to discretionary rulings by the Labor Commissioner. In the interim, the Labor Department uses the following non-binding minimum compensation formula as a guideline: 2 to 3 months salary for each year of service or full salary for remaining period of service up to retirement, whichever is less, subject to a maximum of 50 months salary. Some trade unions have shown reluctance to accept this formula and some companies have offered better packages. The Government also relaxed restrictions on overtime work by women, permitting them to 60 hours of overtime

work per month instead of 100 hours per year. Other planned reforms include amendments to the Shop and Office Act to allow shop and office employees to work on shift basis and an amendment to the wages board ordinance, to encourage outsourcing and subcontracting. These amendments are expected to especially facilitate call center-type operations. A more systematic overhaul of the TEA and IDA would help to bring labor laws in line with international norms.

¶106. In addition to labor reforms, the Government has also prepared policy documents on labor. A joint public and private sector committee has prepared a draft national employment policy. The policy contains seven initiatives to facilitate employment creation through economic growth and improve employability of the current work force. Among other measures, it recommends labor law reforms to facilitate private investment and improvements to tripartite dialogue between the state, private sector and employees to deal with industrial relations issues. The Government has also developed a national productivity policy with the assistance of USAID. It is aimed at developing long-term strategies to enhance productivity in all sectors of the economy.

Trade Unions

¶107. About 15 percent of labor in the industry and service sector is unionized. Labor in free trade zone enterprises tends to be represented by non-union worker councils.

¶108. In 1999, the Government introduced regulations that prohibit unfair labor practices by employers. The law now requires employers to recognize trade unions and the right to collective bargaining, in line with ILO Convention 87 on freedom of association and 98 on the right to organize and bargain collectively. The law compels employers to enter into negotiations with a trade union where the membership is at least 40 percent of the total workforce. Some employers have been reluctant to accept this legislation as they claim it is one-sided and does not contain reciprocal guarantees from trade unions for responsible conduct.

¶109. Unions have complained that the government and some employers, especially in the BOI-run export processing zones, prohibit union access and do not register unions on a timely basis. Employers allege that the Janatha Vimukthi Peramuna (JVP), a Marxist political party that is against private ownership, is provoking labor to strike in the guise of trade union activity. Due to its violent past, employers are generally not in favor of the JVP and its trade union arm, the Inter-Company Trade Union. Prior to the December 2001 parliamentary elections, Inter-Company Trade Union became popular among workers. It also staged strikes and protests in a few companies during ¶2002. Although the JVP continues to agitate against economic reforms and the peace process, its trade union activities are limited to normal union actions.

¶110. In 2002, the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) submitted a petition to the United States Trade Representative seeking suspension of GSP benefits for Sri Lanka due to labor right violations in some factories in the export processing zones. This petition was not acted upon. A similar submission was made to the EU by a local trade union when Sri Lanka applied for benefits under the special incentive arrangements of the GSP. After an audit, the EU is positively considering granting preferential access to Sri Lanka based on protection of core labor standards. The audit did not find serious problems with regard to core labor standards. The BOI has issued a new "labor standards and employee relations manual", instructing BOI companies to recognize trade unions and the right to collective bargaining. According to the manual, where both a recognized trade union with bargaining power and a non-union worker council exist in an enterprise, the trade union will represent the employees in collective bargaining.

¶111. In the plantation sector, union participation rates are as high as 75 percent, though unionization levels are reportedly on the decline. Key public sector entities such as the Ceylon Electricity Board and Sri Lanka Ports Authority also have large unions, which stage protests, often to obtain pay hikes and sometimes to protest anticipated moves towards privatization or restructuring. Most of the major trade unions are affiliated with political parties,

creating a highly politicized labor environment. In what is seen as a positive development, several trade unions with affiliations to main political parties have formed themselves into an organized group, the National Association for Trade Union Research and Education (NATURE), to promote education and training among trade unionists.

Collective Bargaining

¶112. Collective bargaining is not yet popular. Currently, about 50 companies (including a number of foreign-owned firms) belonging to the Employers' Federation of Ceylon (EFC) have collective agreements and use them to conduct negotiations on their behalf.

Labor-Management Relations
¶113. Labor-management relations in the past have
e
been by and large confrontational. This is due to a failure to recognize the need for a social partnership for mutual benefit. The attitude of employers towards workers has changed considerably in the last few years. Employers are becoming more conscious of the need to look after their human resources, and more effort is taken to ensure that workers feel motivated and cared for. Labor-management relations vary from organization to organization; managers who emphasize communication with workers and offer training opportunities generally experience fewer difficulties. US investors in Sri Lanka (including US garment buyers) generally promote good labor management relations and labor conditions that exceed local standards. A few large Sri Lankan firms have started Employee Share Option Schemes. Work stoppages and strikes in the private sector have been on a decline in the past six months. Civil servants other than officers in the police, armed forces, and prison service, also have a right to strike.

ILO conventions

¶114. Sri Lanka is a member of the International Labor Organization (ILO) and has ratified 39 international labor conventions. The labor laws of Sri Lanka are laid out in almost 50 different statutes. Sri Lanka has ratified all eight conventions included in 1998 ILO Declaration on Fundamental Principals and Rights at Work (ILO Core Labor Standards). ILO Convention 138 on minimum age for admission to employment and Convention 182 on worst forms of child labor were ratified during 2000-
¶2001. Sri Lanka ratified ILO convention 105 on Forced Labor in 2003. The ILO, EFC and the AFL-CIO-sponsored American Center for Labor Solidarity are working to improve awareness about core labor standards. The ILO also promotes a Decent Work Agenda in Sri Lanka.

Foreign Trade Zones

¶115. Sri Lanka has 10 free trade zones, also called export-processing zones, administered by the BOI. The oldest, the Katunayake and Biyagama Zones, located north of Colombo near the Bandaranaike International Airport, are fully occupied. The third zone is located at Koggala on the southern coast. Several new mini export-processing zones were opened in the provinces during the last few years. There are nearly 200 foreign export processing enterprises operating in these zones. There are also two industrial parks that have both export-oriented and non-export oriented factories. They are located in Pallekelle, near Kandy in central Sri Lanka and in Seethawaka in Avissawela about 60 kilometers from Colombo.

¶116. In the past, industrialists preferred to locate their factories in close proximity to Colombo harbor or airport to reduce transport cost and save time. The excessive concentration of industries around Colombo has created problems such as scarcity of labor, inadequate infrastructure, environmental pollution, escalation of real estate prices and congestion in the city. Now, the BOI actively encourages the establishment of export-oriented factories in the newly developed industrial zones. The BOI also finds it easier to provide infrastructure facilities and security, as well as to monitor enterprises, when they are located in the zones.

Foreign Direct Investment

US Investments

¶117. Major US companies with investments in Sri Lanka include: Energizer Battery, Mast Industries, Smart Shirts (a subsidiary of Kellwood Industries), Caltex, Sportif, Citibank, Caterpillar, 3M, Cargill, Coca Cola, Celetron, Inc (formerly Tandon), Paxar Corp, Pepsi Co, Warburg Pincus, Worldquest, Fitch IBCR, AES Corporation, American International Group (AIG) and American Premium Water. In addition, IBM, Lanier, NCR, GTE, Motorola, Procter & Gamble, Liz Claiborne, May Department Stores, Federated Department Stores, Tommy Hilfiger, J.C. Penney, the Gap, Sun Microsystems, Microsoft, Bates Strategic Alliance, McCann-Erickson, Pricewaterhouse Coopers, Ernst and Young and KPMG all have branches, affiliated offices or local distributors/representatives. Kentucky Fried Chicken, Pizza Hut, Federal Express, UPS, Domino's Pizza and McDonald's are represented in Sri Lanka through franchises. Numerous other American brands and products are represented by local agents.

¶118. US investment in Sri Lanka is estimated to be in the range of $200 million. Among the recent investors in the power sector are AES Corporation and Caterpillar. AIG insurance entered Sri Lanka in
¶1999. Others are expanding, such as Celetron Inc (memory boards), Citibank, and Mast Inc (apparel and related products). During the past few years, several US companies have formed joint ventures or other partnerships with Sri Lankan companies in the IT sector, mainly in software development.

Non-US Investments

¶119. Major non-US investors include: Unilever, Nestle's, British American Tobacco Company, Mitsui, Pacific Dunlop/Ansell, Prima, FDK and S.P. Tao. Indian Oil Corporation came to Sri Lanka in 2003, investing in an abandoned oil tank farm and the petroleum retailing business of the Ceylon Petroleum Corporation. Leading US and foreign investors which have acquired significant stakes in privatized companies include Caltex; Norsk Hydro of Norway; Kabool Spinning and Textile, Tongyang Nylon, and Hanjung Steel, all of Korea; Nippon Telephone and Telegraph, Mitsubishi Corporation and C. Itoh (A.K.A. Itochu) of Japan; Emirates Airlines of United Arab Emirates; Shell Oil of the UK; and P&O Netherlands.

¶120. Reliable statistics on foreign investment by country are not available. Leading sources of foreign investments are South Korea, Japan, US, Australia, Hong Kong, Singapore, and the U.K. FDI in 2002 was $246 million.

Investment Statistics

¶121. Estimated total foreign investment by sector (in $ millions)

SectorCumulative Total
End 2002
Food & beverage91
Textile/apparel, leather265
Chemical, rubber, plastic115
stic 115
Non-met. Mineral products37
Fabricated metal, machinery58
Other manufactured products101
Services1,056

Total1,723

Source: Board of Investment of Sri Lanka
Note: Investment figures reported here consist of direct investment plus loan financing. The data provided by the BOI are incomplete. They do not include foreign investment that came through non-BOI sources prior to 1994. Foreign investment in the banking and insurance sectors are also not included. Figures reported by the BOI have been converted at average exchange rates prevailing in 2001 and 2002.

End text.

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